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In The

SUPREME COURT OF THE UNITED STATES

October Term, 1962

No. 838

CHARTER WIRE, INC.,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Petitioner prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit dated and entered in the above entitled case on November 28, 1962.

OPINIONS BELOW

The opinion of the Court of Appeals for the Seventh Circuit entered November 28, 1962, is reported at 309 F. 2d 878. The Findings of Fact, Discussion and Conclusions of Law of the District Court for the Eastern District of Wisconsin are reported unofficially at 61-2 USTC 9769 and also appear at pages 147-161 of the printed Appendix filed in the Court of Appeals. Copies of the opinion and judgment of the Court of Appeals are attached hereto as Supplements A and B respectively.

JURISDICTION

The jurisdiction of this Court is invoked under 28 USC § 1254(1).

QUESTIONS PRESENTED

1. Were three instruments executed by Petitioner May 1, 1946, (A. 98-102) and delivered to three partners in partial payment of the partners' interest in the partnership assets an indebtedness of the Petitioner within the meaning of Section 23(b) of the Internal Revenue Code of 1939 and Section 163(a) of the Internal Revenue Code of 1954. ("A." in this petition refers to the appendix filed in the Circuit Court of Appeals and certified to this court as part of the record.)

2. Was an instrument executed by Petitioner February 15, 1954, in an arm's length transaction with a party not in close relationship, (A. 102-3) pursuant to an agreement to be employed by, purchase stock in, and loan money to Petitioner (A. 105-10) an indebtedness within the meaning of Section 23(b) of the Internal Revenue Code of 1939 and Section 163(a) of the Internal Revenue Code of 1954.

STATUTES INVOLVED

The taxable years 1952-1955 are involved, and therefore the applicable statutory provisions involved are Section 23(b) of the Internal Revenue Code of 1939 and Section 163(a) of the Internal Revenue Code of 1954, the pertinent parts of which are printed in Supplement C.

STATEMENT OF CASE

The District Court has jurisdiction of this action under the provisions of Title 28 USCA 1346(a)(1).

A partnership, Charter Wire Company, organized in 1935 with $3,822.25 of capital, consisted of A. W. Mellowes, C. N. Mellowes, his son, and W. L. Scheller (A. 4). The business of the partnership was the drawing of wire. (A. 10) On January 1, 1946, the market value and net worth of the partnership was $240,000.00. (A. 17) The interest of each partner in the assets of the partnership was as follows:

Name	*Percentage of Total*	*Dollar Value of $240,000.00*
A. W. Mellowes	44.1	$105,840.00
C. N. Mellowes	44.1	105,840.00
W. L. Scheller	11.8	28,320.00

The three partners organized Petitioner as a corporation with 680 shares of capital stock of a par value of $1.00 per share. The stock was subscribed and paid for by each partner approximately in proportion to his partnership interest. (A. 7)

The business of the partnership, having a value of $240,000.00, was transferred to petitioner for notes of the petitioner aggregating $66,805.74, representing the value of the partnership assets as carried on its books, issued to each partner in proportion to his partnership interest. (A. 7) All the notes were identical in form. (A. 98-103) Each note bore interest at the rate of 6% per annum, payable monthly; was payable January 31, 1956, and in part or in full prior thereto at the option of petitioner; and payable in the event of the death of a payee in ten equal semi-annual installments.

The excess value of the partnership over the face of the notes was represented in the common stock. To give each partner his just share of that excess value, the common stock had to be subscribed for by each partner in proportion to his partnership interest. As of January 1, 1956, the investment of the three partners in the corporation was as follows: (A. 7, 17)

Name	*Common Stock*	*Notes*
A. W. Mellowes	76,713.33	29,473.12
C. N. Mellowes	76,713.32	29,473.12
W. L. Scheller	20,447.61	7,859.50
	173,874.26	66,805.74

Prior to December 31, 1953, recapitalizations occurred in which the stock was divided into "B" voting and "A" non-voting shares, and the number of shares was increased 12-3. Each partner retained, however, the same proportion of stock and notes as he had in the partnership at the time of the organization of petitioner except that C. N. Mellowes transferred his note to Mary Mellowes in 1946 and A. W. Mellowes disposed of 9500 shares of his "A" stock, leaving him a balance of 4750 after 1951. (A. 114)

The three partners became the officers and directors of the partnership. (A. 8)

At the time petitioner acquired the partnership business, the partnership owed the Marine National Exchange Bank $25,000.00. (A. 7, 36) Not until 1953, during which year the net worth of the partnership increased from $195,560.01 to $247,173.55 (A. 113), did the petitioner borrow more and then the increase was of short duration. Petitioner's borrowings were generally small. (A. 11-2)

The average annual earnings of the partnership during the last five years of its existence were $62,476.29 (A. 17) and averaged nearly that much for the ten years it was in business. (A. 8) A. W. Mellowes and W. L. Scheller were full-time employees of National Lock Washer Company until June 30, 1951. (A. 28)

Petitioner's net worth, as per books, grew from $25,446.19 on December 31, 1946, the end of the first year of operations, to $533,495.20 at the end of 1955 and $803,909.82 at the end of 1958. (A. 113) From January 1, 1946, through 1958 petitioner had net earnings before taxes of $1,694,049.94. (A. 113)

Petitioner had an excellent credit rating from the beginning (A. 35) and a perfect record for discounting bills. (A. 37, 54) The Trial Court stated: (A. 151)

> "It (Petitioner) enjoyed an excellent credit rating and could have borrowed money at a lower rate of interest than the rate provided for in the three notes to stockholders. However, it is not established that a lower rate would be required where the method of financing was on the basis of long-term unsecured notes such as were given for the partnership assets."

On March 3, 1947, about one year after the incorporation of petitioner, the three stockholders of petitioner, at the request of petitioner's bank, subordinated their notes to the obligation of the bank. (A. 63-4, 11) The subordination agreement was terminated March 2, 1954. (A. 11) Marshall never subordinated his note. (A. 11) Subordination was not deemed important at the time because stockholders had no question about being able to pay off both bank and notes. (A. 64)

No agreement existed between stockholders at any time to maintain a fixed proportionality between petitioner's capital stock and debts to stockholders. (A. 35)

The notes to stockholders were carried on the books of petitioner as debt obligations (A. 156) and interest was paid regularly except for the last three months of 1947 when it was accrued and paid in January, 1948. (A. 17, 11) At that time petitioner during a steel shortage had a strike. Petitioner was unwilling to stop shipments, although its plant was not operating, because petitioner was afraid that shipments delayed would never be delivered. Petitioner up to that time had a perfect record of discounting bills and did not want to break that record. (A. 36-7, 54)

Both the Court of Appeals and the District Court found that the notes (Exhibits 11-14) (A. 98-104) were paid by petitioner and cancelled. (A. 155, Supp. A. 24)

The resolution of the Directors of the petitioner providing for the redemption of the notes is dated February 18, 1954. The same resolution provided that new notes bearing interest at the rate of 5 per cent per annum, payable monthly dated April 1, 1954, and maturing March 31, 1960, be offered to stockholders. (A. 113) Decision of the noteholders to take up the new notes was not made immediately, but within two weeks of the cancellation of the notes, the corporate checks received by the noteholders in payment of the old notes were endorsed back to petitioner and new notes, dated April 1, 1954, and maturing January 31, 1960, were issued. (A. 14) The new notes reduced the interest from 6 per cent to 5 per cent, extended the maturity for an additional four years and eliminated the privilege of prepayment on an interest bearing date and the provision for automatic maturity on the death of a holder. (A. 98-103, 111-112)

In 1953, nearly eight years after it was organized, petitioner because it needed new executive talent en-

gaged in negotiations for the hiring of Marshall, a long time friend of C. N. Mellowes, (A. 154) and before World War II, a former employee of the partnership, Charter Wire Company. (A. 72) Marshall agreed to come with petitioner if he could buy an interest in it. He was willing to invest as much as $50,000.00 in petitioner's stock. The shareholders of petitioner were reluctant to sell any stock to Marshall but finally agreed to offer Marshall 3800 shares of common stock at book value for a price of $27,625.28. (A. 154) A. W. Mellowes consented to the sale of stock to Marshall only if the number of shares offered to Marshall was less than 4,000 as A. W. Mellowes and Scheller wanted to retain voting control of petitioner (A. 33), and only if Marshall, in case of the termination of his employment or his death agreed to resell his shares to petitioner at book value. (A. 33)

At the same meeting at which he communicated to Marshall Petitioner's offer to sell 3800 shares of stock, C. N. Mellowes suggested to Marshall that he loan petitioner $10,000.00, to create harmony among the stockholders. (A. 154) At the time the loan was suggested petitioner could have obtained a $10,000.00 loan from a bank. (A. 154) Marshall loaned petitioner $7,427.23. (A. 15) Marshall was interested only in stock interest in a corporation in which he was to be part of the management. The dominant purpose of the loan was not the need of the petitioner for funds but to assure harmonious relations among stockholders. (A. 160) With its excellent credit rating, the petitioner could have readily borrowed money from the banks and probably at a more favorable rate than the 6 per cent rate granted to Marshall. (A. 160) The note to Marshall, however, dated February 15, 1954, ran to January 31, 1956, and

was unsecured. Marshall borrowed money to make the loan at 3¾% (Supp. A. 24) but from a bank and secured the loan with collateral and the endorsement of his father-in-law. (A. 78)

REASONS FOR GRANTING THE WRIT

A.

Transaction with Partners Who Organized Petitioner.

The decision of the court below in the instant case is in direct conflict (1) with the decision of the First Circuit in *Gloucester Ice & Cold Storage Co. v. C.I.R.*, 298 F. 2d 183, *Comm'r. v. H. P. Hood & Sons*, 141 F. 2d 467, and the dissenting opinion of Judge Magruder of the First Circuit in *Talbot Mills v. Comm'r.*, 146 F. 2d 809, 812, adopted in *Gloucester Ice & Cold Storage Co. v. C.I.R.*, supra; (2) with the decisions of the Second Circuit in *Kraft Foods Company v. Comm'r.*, 232 F. 2d 118, *Comm'r. v. O. P. P. Holding Corp.*, 76 F. 2d 11, and *Nassau Lens Co. v. Comm'r.*, 308 F. 2d 39; (3) with the decisions of the Sixth Circuit in *United States v. Title Guaranty Co.*, 133 F. 2d 990, and *Byerlite Corporation v. Williams*, 286 F. 2d 285; and (4) with the decisions of the Ninth Circuit in *Wilshire & Western Sandwiches Co. v. Comm'r.*, 175 F. 2d 718, *Miller's Estate v. Comm'r.*, 239 F. 2d 729, and *Washmont Corporation v. Hendricksen*, 137 F. 2d 306.

The decision of the court below is also in direct conflict with its own decisions in *Jennings v. United States*, 272 F. 2d 842, (See also *Jennings v. United States*, 58-2 USTC §9842 which indicates exact proportions of stock ownership and loans) and *Ortmayer v. C. I. R.*, 265 F. 2d 848, 853-855.

In all of the foregoing cases debt obligations were held valid under circumstances much less favorable to the taxpayer than in the instant case.

In *Gloucester Ice & Cold Storage Co. v. C.I.R.*, (CCA 1) 298 F. 2d 183, the taxpayer deducted $7,000.00 it paid to the holders of its debenture bonds as a payment of interest on indebtedness. The interest was paid on debentures of which 84% were issued in exchange for preferred stock and 16% for new money. The proceeds from the debentures, plus a bank loan, were used to acquire nearly all the capital stock of an ice business.

The court, in its opinion, stated (Pages 184-5):

> "* * * * The Commissioner disallowed the deduction on the ground that the payments constituted dividends within the meaning of Par. 115 and Par. 316 (a) of the respective Codes. The Tax Court agreed with the Commissioner. It conceded that the bonds 'satisfied all of the formal requirements to make the instruments effective as debt obligations' and that the 'record establishes they were treated as debt obligations with interest payments made when due and appropriate accruals to a sinking fund to provide for their retirement at maturity.' Nevertheless, purporting to look through form to substance, it held that the debenture holders had placed their money at the risk of the business, and therefore in effect were stockholders so that payments to them were dividends, because (1) the bonds were held in approximate proportion to the shares of stock, (2) the proceeds of the debentures were used to purchase a fixed asset, i. e., a majority of the stock of Cape Pond Ice Company, (3) the bonds were issued simultaneously with the call of the preferred stock for redemption and (4) the debt-to-equity ratio was disproportionately high, being 15 to 1. We do not agree with the Tax Court.

"The debenture bonds certainly are evidence of debt in form as the Tax Court found. They are also clear evidence of debt in their substantive provisions as well, for by their terms they impose an unqualified obligation to pay interest quarterly on fixed dates at a fixed rate, they impose an unqualified obligation to pay a fixed principal amount on a day certain and within a reasonable time, and they confer upon their holders no voting rights or voice in the management of the obligor under any circumstances whatever. Neither is there any evidence, or indeed any suggestion, of some *sotto voce* understanding that interest would be paid on the bonds only out of income or that the principal amount would not or would not likely be paid at maturity as in *Brake & Electric Sales Corp. V. United States,* 287 F. 2d 426 (C.A. 1, 1961). Moreover, there is no evidence that the petitioner was in such a shaky financial condition or that its business prospects were so dark that in reason the parties to transaction could not have expected the petitioner to meet its obligations on its bonds as they fell due * * *"

* * * * *

" * * * In both form and substance the debentures are out and out evidence of the petitioner's indebtedness. Nor is there anything to suggest that the bonds were a sham in that they did not embody the true intention of the parties, or that they did not or in reason could not have been understood to obligate the petitioner directly according to their terms. Compare *Brake & Electric Sales Corp. v. United States,* supra. * * * "

* * * * *

"There being no element of subterfuge or artifice to escape tax consequences, the bonds speak for themselves. And they speak in clear and unmistakable terms of indebtedness. Therefore there are no disputed questions of fact relevant to the issue to be decided. Inferences cannot avail against patent facts."

In *Wilshire & Western Sandwiches v. Comm'r.*, (CCA 9) 175 F. 2d 718, four persons formed a corporation to go into the restaurant business. The purpose of incorporating was to participate with general creditors for part of their investment in the event that business was unsuccessful. The incorporators also regarded loans as a better investment than stock to obtain returns on and repayment of their capital outlay. The incorporators decided against borrowing from a bank because they considered the receipt of interest desirable. Other pertinent factors were as follows: Stock and notes were issued in equal proportion; one incorporator testified he expected to be repaid the loan only if taxpayer had funds for the purpose; another testified he expected to be paid out of current earnings and would not have insisted on payment to the detriment of the corporation; interest was not paid when due; final payment of principal was late; and initial book entries did not treat notes as loans.

The court reversed the tax court and held that the notes were valid debt obligations.

Neither the district court nor the Court of Appeals in the instant case refer to *Jennings v. United States*, (CCA 7) 272 F. 2d 842, which is an appeal from *Jennings v. United States*, 58-2 USTC 9842. In that case the facts that (a) practically all the stock was held in nearly equal proportions by husband and wife, (b) loans were made to the corporation by the stockholders in proportion to stock holdings, (c) no interest was paid from 1935 to 1948, (d) accrued interest was waived on three occasions, (e) indebtedness to stockholders was payable only when directors deemed it advisable, and (f) by transferring by agreement the liability entry "notes payable" on the books of the corporation to a "net worth"

entry "contributed or paid in surplus" subordinated the stockholder indebtedness to claims of general creditors and delayed payment indefinitely did not deter the Seventh Circuit Court of Appeals from holding the advances by stockholders valid debt obligations. The facts in the instant case are more favorable to Petitioner than they were to the taxpayer in the *Jennings* case.

In "Corporate Indebtedness to Shareholders: Thin Capitalization and Related Problems" by William M. Goldstein, 16 Tax Law Review 1, it is stated:

> "* * * The fact that there is no special treatment of many aspects of corporate indebtedness to stockholders has given rise to an inordinate amount of litigation resulting in a plethora of conflicting judicial opinions, a vast amount of legal literature and several proposals for legislative action."

A reading of the decisions in the cases cited hereinabove from the First, Second, Sixth and Ninth Circuits, as well as the conflicting decisions in the Seventh Circuit in the instant case and the *Jennings* cases together with *Gilbert v. Comm'r.*, (CCA 2) 248 F. 2d 399 and 262 F. 2d 512, *Gooding Amusement Co. v. Comm'r.*, (CCA 6) 236 F. 2d 159, and the decisions in the cases cited in the opinion of the court of appeals in the instant case indicate the need for this Court to establish criteria which if satisfied would constitute an instrument a debt obligation. The need for such criteria has been recognized and adoption urged by the American Law Institute, the American Bar Association, and the Advisory Group on Subchapter C (16 Tax Law Review 1, 63, 66, 71).

The criteria listed by the American Law Institute, which if satisfied would constitute an instrument a debt obligation, are: (16 Tax Law Review 63)

"(1) an unconditional obligation to pay a sum certain in money;

(2) maturity on or before a fixed date;

(3) issuance for adequate consideration or as a dividend;

(4) no subordination to trade creditors generally;

(5) no voting rights, except on default;

(6) interest payments, if any, to be independent of earnings and to be paid by the maturity date of the principal amount."

The proposal of the American Bar Association is to add a new section, 317. (c), to the Code, to read: (16 Tax Law Review 66-7)

"(c) DEBT.—For all purposes of Subtitle A, indebtedness of a corporation shall be deemed to include (but shall not be limited to) any unconditional obligation of a corporation to pay on demand or on a specified date a sum certain in money incurred for an adequate consideration in money or money's worth:

(1) When the obligation is not subordinated by its terms to the claims of trade creditors generally; and

(2) When, by the terms of the obligation, ultimate payment, if any, for use of the principal amount is not dependent upon the earnings of the corporation, and is unconditionally due not later than the maturity date of the principal amount; and

(3) When the principal amount of obligations in the aggregate by stockholders does not exceed by more than ten to one the fair value of the stock held in the aggregate by stockholders immediately after the obligations are issued; or

(4) In the event that an obligation fails to meet one or more of the other requirements of this sub-

section, the taxpayer claiming it to be indebtedness establishes by preponderance of the evidence that such failure was due to the business requirements of the corporation."

William M. Goldstein in 16 Tax Law Review 1, page 71 states:

"THE PROPOSAL OF THE ADVISORY GROUP ON SUBCHAPTER C

"In its report to the Ways and Means Committee, the Advisory Group recommends the adoption of a statutory definition of indebtedness of a corporation. It cites the *Gilbert* case as evidence of the need for such an amendment and says that it is intended to benefit small incorporated businesses and their owners. The new section is supposed to provide an area of safety for obligations 'of the clearest' sort without prejudicing the taxpayer's chances of showing that other types of indebtedness come within the meaning of the various Code provisions."

* * * * *

"The proposed new section 317(c) reads as follows:

(c) Indebtedness.—For purposes of this subtitle, indebtedness of a corporation shall include in all events (but shall not be limited to) any unconditional obligation in writing of a corporation to pay on demand on or before a specified and not unreasonably distant date a sum certain in money incurred upon a distribution to shareholders or for an adequate consideration in money or money's worth and under circumstances which do not negative any reasonable expectation of payment, if—

(1) the obligation is not by agreement subordinated to the claims of trade creditors generally, and

(2) payment, if any, for use of the principal amount is not excessive, is not dependent upon the

earnings of the corporation, and is unconditionally due not later than the maturity date of the principal amount, and

(3) the obligation does not entitle the obligee to vote upon the election of directors of the corporation, and

(4) in case the obligation is initially held or guaranteed by a shareholder of the corporation, immediately after the obligation is created the principal amount of all obligations of the corporation held or guaranteed by its shareholders does not exceed by more than five-to-one the fair value of the outstanding stock of the corporation or the total of the capital and surplus paid-in with respect thereto, whichever is greater."

The need for more uniform rules in the Courts of Appeal of the Circuits was deemed urgent enough for these important bar groups to take action.

The instruments (A. 98-103) executed by Petitioner satisfy the criteria advocated by the foregoing three groups.

The form of the notes (A. 98-103); the book entries setting up the notes as debt obligations (A. 17); payment of interest (A. 17); payment of principal of the notes (A. 155); a ratio of capital to debt of $173,874.26 to $66,825.74 (A. 17, 7); the record of earnings of the partnership (A. 11, 17), all these indicate as stated in *Gloucester Ice & Cold Storage Co. v. C. I. R.*, (CCA 1) 298 F. 2d 183, 185, that "in both form and substance" the notes are out and out evidence of indebtedness.

The facts enumerated in the decision of the Court of Appeals in the instant case are the type of facts which the Tax Court in *Gloucester Ice & Cold Storage Co. v. C.I.R.*, 298 F. 2d 184-85, held in purporting "to look through

form to substance" made the bonds in effect stock and the interest dividends but which the First Circuit Court of Appeals in reversing the Tax Court disregarded stating, page 185, " . . . There being no element of subterfuge or artifice to escape tax consequences, the bonds speak for themselves. And they speak in clear and unmistakable terms of indebtedness. . . Inferences cannot avail against patent facts. . . "

The fact relied on by the Court of Appeals for the Seventh Circuit that the stock and notes of Petitioner were issued in equal proportions does not indicate the notes were not valid debt obligations as that was the natural result of the incorporation of a partnership business where the capital structure consists of notes and stock. *Miller's Estate v. Comm'r.*, (CCA 9) 239 F. 2d 729.

The fact as stated by the Court of Appeals that the stockholders of Petitioner subordinated their notes to the obligations of a bank is a normal occurrence in the operation of a business which needs credit. Subordination of notes to *only one* creditor is no different in effect than giving a bank other security which it could have required in lieu of subordination. Subordination was not considered important by the Court of Appeals for the Seventh Circuit in *Jennings v. U. S.*, 272 F. 2d 842, 843, and *Ortmayer v. C.I.R.*, 265 F. 2d 848, 853-854.

The fact as stated by the Court of Appeals that the assets of the partnership exchanged for the notes of the corporation were found to be essential to the conduct of Petitioner's business is a natural result of the incorporation of a partnership. (*Miller's Estate v. Comm'r.*, (CCA 9) 239 F. 2d 729) From the reasoning of the Seventh Circuit, it would follow you cannot issue debt obligations to partners upon incorporation of a partnership.

The fact relied upon by the Court of Appeals that Petitioner called in the notes prior to maturity and issued new notes with a different maturity has no significance. Petitioner did only what the terms of the notes authorized. (A. 98-103)

The fact that payment of interest on the notes was suspended for three months, relied upon by the Court of Appeals, resulted from a shortage of cash arising from a strike, from a reluctance of Petitioner to discontinue steel shipments, although its plant was not operating, because of fear that shipments delayed would never be delivered, and from a desire to continue a perfect record for discounting bills. These appear reasonable grounds for deferring interest payments for three months.

The fact relied upon by the Court of Appeals that Petitioner did not set up a sinking fund does not indicate an intention not to retire the notes at maturity in the face of a ratio of a debt to equity investments of $66,825.74 to $173,874.26 (A. 17, 7) at the time of incorporation, in the face of partnership earnings averaging $62,476.29 for the five years prior to its incorporation (A. 17) and a net worth of $240,000.00 at the time of incorporation, in the face of large corporate earnings and net worth (A. 113) with small and infrequent bank borrowings (A. 11-12), and in the face of the actual payment of the notes prior to maturity (A. 155), no noteholder being under legal obligation to subscribe for the new notes offered. (A. 113)

B.

Transaction with Marshall.

The decision of the court below in the instant case is in direct conflict with a decision in the Second Circuit, *Kraft Foods Company v. Comm'r.*, 232 F. 2d 118, 123;

with a decision in the Fifth Circuit, *Sun Properties v. U. S.*, 220 F. 2d 171; with a decision in the Eighth Circuit, *Potter Electric Signal and Manufacturing Co. v. C.I.R.*, 286 F. 2d 200; and a decision in the Ninth Circuit, *Wilshire & Western Sandwiches, Inc. v. Comm'r.*, 175 F. 2d 718.

In *Wilshire & Western Sandwiches, Inc. v. Comm'r.*, 175 F. 2d 718, 720, the court stated:

> "* * * It is apparent that had the dealings been with an independent third party no question as to the propriety of the interest deduction could have been raised * * *"

In *Potter Electric Signal and Manufacturing Co. v. C.I.R.*, 286 F. 2d 200, the Potter Trust purchased a building and leased it to petitioner. The Potter Trust owned all the outstanding common stock and 300 of the 365 shares of petitioner's preferred. The question was as to the reasonableness of the rent. The court of appeals, page 203, held the following rule of law applicable:

> "'* * * Where there is a close relationship between lessor and lessee and in addition thereto there is no arm's length dealing between them, an inquiry into what constitutes reasonable rental is necessary.'"

For the purpose of Par. 267, the 1954 Code* disallows a deduction for losses from sales or exchanges of property and deduction of expenses on interest on transactions between same taxpayers. They are defined as members of a family, an individual and a corporation more than 50% of the stock of which in value is owned by the individual, two companies more than 50% in value of the stock of each of which is owned by the same individuals and certain fiduciary relationships.

*26 U.S.C. § 267

The transaction between petitioner and Marshall was at arm's length. Each tried to make the best bargain possible. (A. 29-35, 73-77, 79-81) Aside from a prior business association and close friendship with C. N. Mellowes, there was no relationship between the parties. (A. 29, 30) Marshall had a job paying him approximately $12,000.00 a year, (A. 75) the same salary at which he was hired by petitioner, plus a bonus in an undetermined amount. (A. 104-5) Marshall was not interested primarily in a job. He also wanted a stock interest in a company with a good growth potential. A. W. Mellowes at first was unwilling to sell Marshall stock. He suggested a profit sharing arrangement. (A. 31) A. W. Mellowes finally consented to the sale of stock provided the number of shares purchased by Marshall was less than that owned by Scheller as A. W. Mellowes wanted voting control to be in himself and Scheller. (A. 33)

It is important that the confusion that exists in the area of defining debt obligations be not enlarged by permitting courts to give a meaning to arm's length transactions other than that which appears upon the face of the instruments giving the transaction effect.

CONCLUSION

For the foregoing reasons, this petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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SUPPLEMENT A

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Nos. 13695, 13696 SEPTEMBER TERM, 1962 SEPTEMBER SESSION, 1962

CHARTER WIRE, INC.,
Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

On Appeal from the judgments of the United States District Court for the Eastern District of Wisconsin.

November 28, 1962.

Before SCHNACKENBERG, CASTLE and SWYGERT, *Circuit Judges.*

SWYGERT, *Circuit Judge.* This is an appeal from a judgment dismissing two consolidated actions by taxpayer, Charter Wire, Inc., for refunds of income tax for the years 1952 through 1955. During this period taxpayer paid to noteholders, who were also its sole shareholders, a total of $15,489.38 and deducted the payments as interest on its tax returns. The Commissioner of Internal Revenue determined that the payments represented dividend distributions rather than interest on "indebtedness" as contemplated by Section 23(b) of the Internal Rev-

enue Code of 1939[1] and Section 163(a) of the Internal Revenue Code of 1954. The District Court, in dismissing the actions sustained the determination.

Taxpayer, a Wisconsin corporation, is engaged in the business of drawing and rolling wire. It was formed in 1946 to take over the assets and business of a partnership composed of Alfred W. Mellowes, Charles N. Mellowes, and William L. Scheller. At the time of incorporation, the partnership had a book value net worth of $66,805.74, and a going concern value of $240,000. The original capital of the partnership was $3,822.65. The average annual earnings of the partnership during the last five years of its existence were $62,476.29.

The partnership assets were transferred to the corporation in exchange for six per cent promissory notes in the amount of $66,805.74. The notes were issued to the former partners in the following proportions:

	Amount of Note	Percentage Total
Alfred W. Mellowes	$29,473.12	44.1%
Charles N. Mellowes	29,473.12	44.1%
William L. Scheller	7,859.50	11.8%
Total	66,805.74	100.0%

[1] Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) Interest.—All interest paid or accrued within the taxable year on indebtedness, * * *.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

Section 163(a), Internal Revenue Code of 1954 (26 U. S. C. 1958 ed., Sec. 163), is substantially the same as the section set out above.

In exchange for $680, one dollar par value stock was issued to the former partners in the following proportions:

	Amount Contributed	Number of Shares Issued	Percentage of Total
Alfred W. Mellowes	$300.00	300	44.1%
Charles N. Mellowes	300.00	300	44.1%
William L. Scheller	80.00	80	11.8%
Total	680.00	680	100.0%

The stock included the good will value of the enterprise.

In 1950 and 1951 taxpayer recapitalized by issuing two classes of stock, one voting and one non-voting, in exchange for the original issue. The proportionate holdings of the three stockholders remained unchanged.

From March, 1947 to March, 1954 the stockholders subordinated their notes to obligations arising from corporate borrowing from the Marine National Exchange Bank of Milwaukee.

Interest has been regularly paid on the notes save for one three-month period during the latter part of 1947. In that year, the taxpayer's production was hampered by a six week strike. The strike occurred during a steel shortage. Taxpayer was unwilling to stop steel shipments from its suppliers, although its plant was not operating, because it felt that any shipments delayed would never be delivered. To meet its trade obligations and because of a desire to maintain its record of discounting bills, and taking into consideration the tight cash position of the corporation, the directors voted to suspend payment of interest on the notes given in exchange for the partnership assets. Interest was suspended during October, No-

vember, and December, 1947. Back interest covering this period was paid in 1948.

Taxpayer in 1953 negotiated for the hiring of one J. Willard Marshall for an executive position. Marshall agreed to come with the corporation only if he could buy an interest in it. He was willing to invest up to $50,000 in corporate stock. The shareholders were reluctant to sell any of the stock but finally offered to sell Marshall 3,800 shares of common for $27,625.28. At the same meeting Charles N. Mellowes suggested Marshall loan the corporation $10,000. Marshall finally agreed to loan $7,427.23 at six per cent interest. He borrowed this money from a bank at three and three-fourths per cent interest. His "loan" bore the same ratio to the total amount represented by the stockholders' notes as his share of voting stock bore to the total voting stock then issued.

Pursuant to a resolution of the board of directors in February, 1954 the four notes of the stockholders (including Marshall's), which had a maturity date of January 31, 1956, were paid by corporate checks and the notes were cancelled. The checks were endorsed back to the corporation within two weeks and, in conformance with the resolution, new five per cent promissory notes were issued having a maturity date of January 31, 1960. The new notes eliminated the provision of the original notes which provided that they were to mature automatically on the death of the holder.

At all times the notes in question were carried as debt obligations on the books of the corporation.

The burden of establishing that the advances were loans is upon the taxpayer. *Arlington Park Jockey Club v. Sauber,* 262 F. 2d 902 (7th Cir. 1959). Even though the taxpayer has various explanations for each of its

actions taken separately, the finding that the totality of facts indicates a risk-capital investment should not be set aside unless we are prepared to say that the District Court was clearly erroneous. *Brake & Electric Sales Corp. v. United States*, 287 F. 2d 426 (1st Cir. 1961). A review of the undisputed facts and a reading of the clear, concise analysis of these facts contained in the opinion filed by the District Court convinces us that we would be making an unwarranted departure from the "clearly erroneous" doctrine were we to reverse the District Court's determination.

There is no doubt that the stockholders of taxpayer at all times held their notes in direct proportion to their equity ownership in the corporation. This raises a strong inference that the loans represented capital investment. *Arlington Park Jockey Club v. Sauber, supra.* The stockholders' subordination of their notes to the obligations held by the bank was properly considered by the District Court as bearing on the true nature of the transactions in question. *P. M. Finance Corp. v. C. I. R.*, 302 F. 2d 786 (3rd Cir. 1962).

The assets of the partnership exchanged for the notes of the corporation were found to be essential to the conduct of the taxpayer's business. This is another factor that may be used to weigh the balance in favor of the District Court's determination. *Brake & Electric Sales Corp. v. United States, supra.* In the latter case the absence of an unfavorable or disportionate debt-equity ratio was not deemed controlling and the finding of an equity relationship was affirmed on the basis of other considerations. Taxpayer here argues strongly that it had an extremely favorable debt-equity ratio during the entire period in question and we can find nothing in the record which would lead us to believe otherwise; however, we

believe the many other factors present warrant an affirmance of the decision.

Expectation of payment at maturity is a good indication of the existence of a debt. This expectation, however, must be more than a theoretical one, and in retrospect if it can be shown that the stockholders making the advances were little concerned about the matter of payment of the principal when due, then the taxpayer's position is greatly weakened.

Here there was no evidence of a sinking fund having been established to provide for retirement of the notes at maturity—a fact given considerable weight in establishing the existence of a debtor-creditor relationship in *Gloucester Ice & Cold Storage Co. v. C. I. R.*, 298 F. 2d 183 (1st Cir. 1962). The record shows that the noteholders had complete control of the corporation and on several occasions exhibited their primary concern for their position as stockholders in preference to that of creditors. The stockholders subjugated their role as creditors when it was for the corporation's benefit. They called in the notes prior to maturity, issued new notes with a different maturity date, subordinated their notes without protest to that of a bank when asked to do so, and suspended payment of interest for one three-month period; thus they appear to have been little interested in their role as creditors. Their conduct as above related makes it apparent that they relied on their control as stockholders for security rather than on their status as creditors.

We further agree with the District Court in its analysis of the nature of the loans made to Marshall. The District Court noted:

> "Especially damaging to the taxpayer's suggested interpretation of the facts of this case are the transac-

tions with respect to the loan made to the corporation by Marshall. Upon the urging of Charles N. Mellowes that the funds supplied would aid in company expansion and that the loan would make him feel more like the other stockholders, Marshall, who was interested in only an equity investment, made the loan requested. To illustrate that this was not such a loan as would entitle taxpayer to a deduction for interest paid thereon, we note that the dominant purpose of the loan was not the need of the corporation for such funds, but to assume harmonious relations with other stockholders. It is abundantly clear that with its excellent credit rating, the corporation could have readily borrowed money from the banks, and probably at a more favorable rate than the 6% rate granted to Marshall. The fact that Marshall was able to borrow the money necessary to make the loan to the corporation at 3½% is consistent with this finding. After the consummation of the stock purchase and loan agreement, Marshall owned 10% of each class of stock and 10% of the outstanding notes owed to stockholders. This proportionality could be maintained as long as Marshall remained in the employ of the corporation since the corporation had an exclusive option to buy Marshall's stock in the event that he should desire to dispose of it during his lifetime, and if it exercised the option, the corporation was also obliged to purchase his note in the same proportionate amount. *The dealings with Marshall clearly indicate that the taxpayer and its shareholders treated the 'loans' as an integral portion of the contributed capital of the corporation.*" (Emphasis supplied.)

The judgment of the District Court is affirmed.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit.

SUPPLEMENT B

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Chicago 10, Illinois

Wednesday, November 28, 1962

Before

Hon. ELMER J. SCHNACKENBERG, Circuit Judge
Hon. LATHAM CASTLE, Circuit Judge
Hon. LUTHER M. SWYGERT, Circuit Judge

No. 13695-13696

CHARTER WIRE, INC.,
Plaintiff-Appellant,
vs.
UNITED STATES OF AMERICA,
Defendant-Appellee.

Appeals from the United States District Court for the Eastern District of Wisconsin.

This cause came on to be heard on the transcript of the record from the United States District Court for the Eastern District of Wisconsin, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgments of the said District Court in this cause appealed from be, and the same are hereby AFFIRMED, in accordance with the opinion of this Court filed this day.

SUPPLEMENT C

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

* * *

"(b) All interest paid or accrued within the taxable years on indebtedness except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxes imposed by this chapter."

INCOME TAX REGULATIONS 118

3.23 (b)-1 Interest. Interest paid or accrued within the year on indebtedness may be deducted from gross income, except that interest on indebtedness incurred or continued to purchase or carry obligations, such as municipal bonds, first Liberty loan 3½ percent bonds, or (in case of a taxpayer not an original subscriber) obligations of the United States issued after September 24, 1917, the interest upon which is wholly exempt from tax is not deductible. Interest paid or accrued within the year on indebtedness incurred or continued to purchase or carry (a) obligations of the United States issued after September 24, 1917, the interest upon which is not wholly exempt from the taxes imposed by title I of the Act, or (b) (in the case of an original subscriber) obligations of the United States issued after September 24, 1917, the interest upon which is wholly exempt from the taxes imposed by title I of the Act, is deductible in accordance with the general rule.

Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Payments made for Maryland or Pennsylvania ground rents are not deductible as interest but may, if a proper business expense, be deducted as rent.

Interest calculated for cost-keeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in computing net income. (See, however, §3.22(a)-18 and section 121 of the Act.) In the case of banks and loan or trust companies, interest paid within the year on deposits such as interest paid on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company may be deducted from gross income. As to other amounts of interest not deductible under section 23(b) of the Act, see section 24(c), as added by the Revenue Act of 1937 (50 Stat. 828; 26 U.S.C., Sup. III, 24(c)).*† [As amended by T.D. 4791, Jan. 14, 1938, 3 F.R. 100]

1954 INTERNAL REVENUE CODE

"§ 163. Interest

(a) General rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Code of Federal Regulations
Title 26 Internal Revenue 1954

§ 1. 163-1 (a) Except as otherwise provided in sections 264-267, inclusive, interest paid or accrued within the taxable year on indebtedness shall be allowed as a deduction in computing taxable income."